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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D.C. 20505

National Intelligence Council

15 September 1981

MEMORANDUM FOR: Members of the SIG on East-West Economic Relations

FROM : Henry S. Rowen
Chairman, National Intelligence Council

SUBJECT : Yamburg Gas Pipeline

1. We have examined the politics and economics of the Yamburg pipeline from a West European perspective. We conclude that:
 - o The political cards are stacked in favor of building the pipeline.
 - o The Europeans have a strong bargaining position regarding the gas price and the Soviets may well be disappointed on their net earnings.
 - o The future European market for the Soviet gas looks more and more questionable.
2. The attached memorandum develops these points and suggests some implications for U.S. policy.

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Attachment:
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14 September 1981

European Political and Economic Considerations
in the Yamburg Pipeline

1. Construction of the Yamburg gas pipeline from the USSR has powerful political support in Western Europe but there is growing uncertainty as to whether there will be a market for that much Soviet gas. In Western Europe there are strong political constituencies favoring, and virtually no political opposition to, construction of the pipeline.

- o Many West Europeans and Japanese firms are anxious to sell the vast amounts of pipe, compressors, and other equipment.

- o The Europeans and Japanese regard the prospective Soviet hard currency earnings from the pipeline as necessary to sustain, if not to expand, the Soviet market for their exports in the longer term.

- o Both European governments and private interests favor diversification of sources of energy supply, and consider Soviet gas to be more reliable than some other energy sources.

- o The dominant European view is that closer ties with the Soviet Union on balance reduce the chances of aggressive Soviet behavior.

- o And many believe, or want to believe, that a contented Russian bear is generally less dangerous than a hungry one.

2. This does not mean, however, that all will be smooth sailing for the pipeline project. The project has already been reduced in scope from a dual line to a single line, carrying 2.9 billion cubic feet per day of gas to Western Europe, or some 60 percent of the capacity of a dual line. Agreement in principle has been reached with most key European countries on financing terms, but the quantities of Soviet gas each country will need and the prices to be charged are still very uncertain and may be the subject of lengthy negotiations. Although it would be difficult for the Europeans to back out of the single pipeline, the odds are turning strongly against construction of the second line at any time in the foreseeable future.

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3. It is no longer certain that demand for gas in Western Europe will be sufficient to justify building the pipeline. The pipeline project was conceived during a period of extreme tightness in energy markets and rapidly rising oil prices. Almost any new source of energy was viewed favorably as a means of reducing market pressure and dependence on Persian Gulf supplies. But during the past year or so the oil shortage has turned to glut and perceptions of energy prospects have been changing rapidly. The growing evidence of a large scale conservation response to higher energy prices has led to much lower projections of energy demand. The gas market also has weakened. In 1980 for the first time in decades, consumption of natural gas in Europe declined (by 4 percent) -- an occurrence which must have been a great shock to utility companies. The decline in gas consumption appears to have continued in 1981. These recent trends were not factored into the latest official European gas projections, which were produced for the IEA in 1980. More recent company projections for European gas demand in 1990 are generally 10-15 percent lower than the official ones; Shell's forecast is 20 percent lower.

4. Even using the official projections, there may not be room for all the Soviet gas even a single pipeline could carry by 1990. In both West Germany and Italy domestic production and existing agreements to import from the Netherlands, Algeria, Norway, and Nigeria, about cover projected gas consumption in 1990. In France and Belgium, substantial additional agreements are needed to cover projected gas consumption, but most of the additional requirements could be met from sources other than the USSR if these countries were willing to substantially increase their dependence on African producers. For Western Europe as a whole, the Shell forecast could not accommodate any gas from the new Soviet pipeline.

5. Future trends in gas consumption will of course be strongly affected by movements in the price of gas relative to other energy sources. Some forecasts apparently assume that gas prices will rise faster than crude oil prices, a trend that would dampen the demand for gas. At prices above residual fuel, natural gas will probably be backed out of low value applications in industry and electricity generation. And because of long lead times in delivering new gas projects and high capital investment costs of developing infrastructure, the European utilities must price gas now to guarantee a market in the late '80s. Should Moscow be willing to lower its prices to, for example, the equivalent of residual fuel oil, it could probably assure a market for its gas. But price bargaining will be difficult and probably lengthy. Unless West European governments put strong pressure on the utility companies to come to terms with Moscow on Soviet gas, many months may pass before agreement is reached.

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6. Should Moscow agree to sell gas from the pipeline at a price equivalent to residual fuel oil (about \$4 per thousand cubic feet), its hard currency earnings from this source would be only \$4.2 billion, or about 40 percent of the projected earnings with the dual pipeline at a crude oil parity price (about \$6 per thousand cubic feet). These earnings would enable the Soviets to offset only about one third of the current hard currency earnings from oil exports, which are likely to decline sharply.

The US Role. A US attempt to dissuade the Europeans on political grounds from building the pipeline almost certainly will not work. Indeed, strong political pressure could be counterproductive since the Europeans regard the pipeline as their problem and will not easily tolerate overt US interference.

On the other hand, the US could help stimulate, focus, and publicize the uncertainties concerning the market for Soviet gas in Europe. The fact that it is difficult to find enough room for the gas, that demand projections are likely to decline further, and that prices are softening could be more pointedly discussed and more broadly publicized. With respect to alternative sources, the most relevant are Algeria, Nigeria and Norway. A definite US withdrawal from the Algerian and Nigerian LNG markets would improve the Europeans' bargaining position with these countries. Although Algeria at least has not been regarded as a secure energy source, both that country and Nigeria will badly need the income from large additional gas sales and will, in their own interests, have to accept reasonable terms. Beyond the 1980s Norway is the only large nearby alternative source of additional gas for Western Europe. US influence on Norwegian gas policy is minimal, but the gas resources needed to fill West European needs are almost certainly there.

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